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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

WESTERN DIVISION

NATIONAL CREDIT UNION ADMINISTRATION BOARD AS CONSERVATOR FOR WESTERN CORPORATE FEDERAL CREDIT UNION, Plaintiff, vs. ROBERT A. SIRAVO, et al., Defendants.	No. CV 10-01597 GW (MANx) **DIRECTORS' REPLY TO NCUA'S OFFER OF ADDITIONAL ALLEGATIONS** Honorable George H. Wu Courtroom 10 312 North Spring Street Date: January 31, 2011 Time: 8:30 a.m. Courtroom: Los Angeles, 10

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I. INTRODUCTION

Claim One of the First Amended Complaint, Doc. 84 ("FAC") fails to allege anything that might overcome California's Business Judgment Rule. As the Court correctly held in its Tentative Ruling, Doc. 110 ("Tentative Ruling"):

> Fraud, breach of trust, conflict of interest, bad faith, oppression, corruption, complete abdication of responsibility, willful ignorance and gross overreaching are fairly glaringly absent from the allegations in connect with the FAC's first two claims.

Tentative Ruling at 8 (Doc. 110, at 9). The same is true of the Plaintiff's Offer of Additional Allegations, Doc. 111 (the "Offer"): "[G]laringly absent" from the Offer is anything that might satisfy this standard. Instead, over and over again the Offer uses the language of ordinary negligence, as if the Business Judgment Rule did not exist.

The Offer's proposed allegations fall into three categories: allegations about WesCorp's budget and interest rate spreads; allegations about concentration limits and Option ARMs; and allegations about damages. None adds anything of substance. The budget allegations rehash allegations made in the FAC or offer economic theorizing contradicted by the FAC (and by common sense). The allegations about concentration limits and Option ARMs also rehash the FAC (albeit at greater length) and largely quarrel with the content of the Directors' decisions, rather than the process they employed to reach those decisions. And the allegations of damages are, as before, a red herring, irrelevant to the Business Judgment Rule.

The Offer's legal discussion is a (barely) disguised motion for reconsideration that fails to comply with the Local Rules. It raises nothing new, and the points it makes remain demonstrably wrong.

In short, the Court should affirm the Tentative Ruling and deny leave to amend. The Directors should be dismissed from this case.

II. ARGUMENT

A. The NCUA's proposed allegations do not come close to meeting the standards set by the Tentative Ruling

This Court correctly held that the investment decisions challenged by the NCUA are precisely the type of business decisions protected from second-guessing by judges and juries. Tentative Ruling at 7-8. Because these decisions deserve protection, the NCUA's claims must be dismissed unless its proposed allegations establish an exception to the Business Judgment Rule.

California's Business Judgment Rule provides only limited exceptions. It does not protect decisions involving fraud, conflict of interest, oppression or corruption. *FDIC v. Castetter*, 184 F.3d 1040, 1046 (9th Cir. 1999). It does not protect decisions made by directors who wholly abdicate corporate responsibility and close their eyes to corporate affairs. *Id.* It also does not protect actions taken without a reasonable investigation, but *only* where there are "(1) allegations of facts which would reasonably call for such an investigation, or (2) allegations of facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business judgment." Tentative Ruling at 6 (quoting *Lee v. Interinsurance Exchange*, 50 Cal. App. 4th 694, 715, 57 Cal. Rptr. 2d 798 (1996)).

As this Court noted, allegations establishing any of these exceptions are "glaringly absent" from the allegations of the FAC. Tentative Ruling at 8. The Offer is more of the same, and does not give this Court what it asked for. Thus, the Offer does not save the FAC's Claim One.

B. The NCUA's proposed allegations do not establish an exception to the Business Judgment Rule

The proposed allegations do not come close to establishing an exception to the Business Judgment Rule. The Offer does not even hint at fraud, breach of trust, conflict of interest, bad faith, oppression, corruption, complete abdication

of responsibility, willful ignorance, or gross overreaching. Instead, the NCUA relies solely on claims of an inadequate investigation. Yet, as this Court noted, it is clear from the facts alleged in the FAC that "a reasonable – even if imperfect, or flawed in hindsight – 'investigation' took place here." Tentative Ruling at 6 n.4. The Offer does not call into question this basic conclusion.

1. The allegations about the budget rehash the allegations of the FAC and do not establish an exception to the Business Judgment Rule

The Offer alleges that the Budget Committee reviewed and approved budgets. Offer at 2:12-4:2. It says the budgets forecast increases in investment income and net interest income, and concludes that increased income necessarily meant increased investment risk. *Id.* at 3:8-24. It alleges that the materials provided to the Budget Committee did not specify how WesCorp would change its investment strategy to earn more income, or what additional risk this would entail. *Id.* at 3:25-4:2.[1] *See* part II.B.1.a below.

The Offer alleges that interest rate spreads were tightening, and (erroneously) concludes from this that Defendants knowingly were taking on more risk. Offer at 4:14-5:22. Finally, it offers the legal conclusion that this was not prudent. Offer at 5:23-8:6. *See* part II.B.1.b. below.

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[1] The NCUA nowhere explains why changes in investment strategy should be presented to the Budget Committee, as opposed to, say, the Asset and Liability Committee ("ALCO"), which actually did look at the composition of WesCorp's investment portfolio and received monthly packages, often exceeding 100 pages, filled with charts, graphs, tables and other details on WesCorp's portfolio and individual investments, including a table listing assets by type and concentration limits. The Offer refers to the economic discussions and forecasts typically contained in section 2 of these monthly ALCO books (*e.g.*, Offer at 12:26-13:18), but chooses to ignore the listings of assets by type and by concentration limit in section 3 of these books, and the pages of tables listing specific assets and concentrations, and discussing investment strategy, in section 6 of these books. *See* FAC ¶ 71 (admitting that defendants tracked assets by type and by concentration limits).

a. The allegations about the Budget Committee do not establish an exception to the Business Judgment Rule

The proposed allegations use more words (Offer at 2:12-4:2) but essentially rehash the allegations of FAC ¶ 65. There, the NCUA claimed that the budget contained "detailed information about the proposed projected expenses and projected fee income" but insufficient information about investment income, investment expense and net income interest, "except the monthly projected totals." *Id.* Just as FAC ¶ 65 failed to establish a lack of reasonable investigation, so too do the proposed allegations fall short.

In particular, the proposed allegations do not even attempt to satisfy the standard set forth in *Lee*, 50 Cal. App. 4th at 715 (cited by the Tentative Ruling at 8). The NCUA does not offer facts that explain how the Budget Committee or the board dealt unreasonably with the information available to it. The NCUA does not offer facts that demonstrate what, at the time, should have alerted the Budget Committee to a need for more or different information. The NCUA does not offer facts that demonstrate what more or different information would have revealed. In other words, the Offer alleges no new facts that satisfy *Lee*.

That is enough to defeat these allegations, but that is not the only thing wrong with them. The NCUA assumes – without alleging any facts or citing anything on which to base such an assumption – that increased investment income necessarily means increased risk. Offer at 3:8-11. But that is not necessarily true, and certainly cannot be accepted as an article of faith. The level of risk depends on numerous other factors. Even if we assume as a matter of economic theory that a higher rate of return from a given level of assets *always* means increased risk, the NCUA does not allege facts showing that WesCorp projected a higher rate of return from a given level of assets. For example, if a WesCorp budget had projected a 35% increase in income with *no* increase in assets, that would be an increased return on the assets, and economic theory

would suggest some increased risk. But if instead WesCorp's budget projected a 35% increase in income and a *doubling* of assets, that would be a decreased return on assets (despite the higher aggregate income), hence a *reduction* of risk.

While the FAC alleges that WesCorp was increasing its assets, neither the FAC nor the Offer suggests that WesCorp projected an increased rate of return for a given quantity of assets. Indeed, the FAC alleges exactly the opposite: FAC ¶ 45 alleges "Budgeted Net Interest Income" and "Budgeted Average Earning Assets" from 2002 through 2008. If one divides the former into the latter, one sees that the income/assets ratio, while fluctuating, is highest in 2002 and declines sharply from 2006 through 2008 (while always below the 2002 level). Thus, even if one accepts the NCUA's thesis that an increased income/assets ratio *necessarily* means higher risk, the FAC's own allegations torpedo the NCUA's premise.[2] Far from establishing an exception to the Business Judgment Rule, the Offer does not even satisfy the "plausibility" standard of *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570, 127 S. Ct. 1955 (2007), and *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009).

b. The allegations about tightening investment spreads do not establish an exception to the Business Judgment Rule

The same defects – warmed-over allegations and conclusory thinking, traveling under the banner of bad economics – mars the NCUA's next set of proposed allegations. Offer at 4:3-8:6. The NCUA alleges that "investment spreads" began to tighten, starting around June 2006. Offer at 4:3-5:9. By this, the NCUA means that the difference began to shrink between the yield on some benchmark investment (the NCUA mentions the 30-day LIBOR interest rate, *id.* at 4:14-15) and the yield on the mortgage-backed securities that WesCorp was

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[2] The Directors do not suggest that the interest income/assets ratio, without more, has meaning; their only point is that the NCUA's factual allegations destroy the premise of its (economically flawed) conclusion.

buying. The NCUA has its terminology wrong[3] – what it means is usually, in the context of bonds, called the "credit spread"[4] although sometimes is called the "risk premium." Terminology aside – let's just call it the "spread" – what the NCUA says is that, as the spread between the highest-tranche AAA investments and lower-rated investments shrunk, or tightened, WesCorp had to take on more risk to maintain the spread projected in its budgets. Offer at 4:20-21, 5:10-15.

These allegations simply repeat allegations made in FAC ¶¶ 75-77. And they do nothing to establish an exception to the Business Judgment Rule. They simply take issue with the level of risk the Directors chose – precisely the type of decision protected by the Business Judgment Rule. Tentative Ruling at 9.

In addition, these allegations rest on a fundamental fallacy: If spreads tightened, it was because the market perceived *less* risk, not more. Spreads increase when the market perceives increasing risk, and decrease when the market perceives less risk.[5] Thus, if one changes investments to maintain a given

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[3] "Investment spread" is a term used for insurance-based investment products such as annuities; it means "the difference between the investment earnings on the premiums and the portion of those earnings credited to the contract holder" (*Smith v. John Hancock Ins. Co.*, No. 06-3876, 2008 WL 4072585, at *1 (E.D. Pa. Sept. 2, 2008)) or "the difference between income earned on investments and interest credited to its customer accounts with its retail and institutional spread products" (*Credit Suisse First Boston Corp. v. ARM Financial Group, Inc.*, No. 99 CIV 12046 WHP, 2001 WL 300733, at *2 (S.D.N.Y. Mar. 28, 2001)). That's not what the NCUA means.

[4] *E.g.*, *Johnson v. Radian Group, Inc.*, Civ. No. 08-2007, 2009 WL 2137241, at *6, *8, *19-*20 (E.D. Pa. July 16, 2009); *In re MoneyGram Int'l, Inc. Sec. Litig.*, 626 F. Supp. 2d 947, 961, 964, 972 (D. Minn. 2009) (quoting SEC filings as saying, "Market conditions at September 30, 2007 primarily reflect wider credit spreads due to heightened concerns regarding the risk of securities backed by mortgage-based collateral, historically low levels of activity in the related market for these securities and a tighter credit market.").

[5] The SEC filings quoted in *MoneyGram* reflect exactly this, and in the context of MBS. 626 F. Supp. 2d at 964. *See also* John Krainer, "What Determines the Credit Spread?," *FRBSF Economic Letter*, No. 2004-36, at 3 (Dec. 10, 2004) (explaining credit spreads and concluding, as of 2004, that "[t]he

(continued…)

spread, one is merely holding constant the market's perception of the level of risk, not increasing that risk.

The NCUA posits that, as the spread between LIBOR and Bond A declined, say, from 50 basis points ("b.p.") to 40 b.p., WesCorp decided to switch from Bond A to lower-rated Bond B, which (now) offered a 50 b.p. spread. *See* Offer at 4:14-21. But it does not follow that WesCorp has chosen to incur more risk: it still holds an investment with a 50 b.p. spread over LIBOR. Once again, the NCUA's theorizing, far from establishing an exception to the Business Judgment Rule, is not even plausible.

The NCUA's remaining allegations about investment spreads are legal conclusions, bereft of facts. Offer at 5:16-7:24. They parrot the words used to allege ordinary negligence (Offer at 6:20-7:24) and, as such, are entitled to no deference. *Iqbal*, 129 S. Ct. at 1949; *Warren v. Fox Family Worldwide, Inc.*, 328 F.3d 1136, 1139 (9th Cir. 2003). And the conclusory words are undercut by what few facts the NCUA does plead. The NCUA alleges for example that the Directors received documents that described the risks of mortgage backed securities ("MBS") and tightening investment spreads generally. Offer at 4:25-5:9. Under the facts as alleged, the Directors were receiving information and making decisions based on that information. These allegations do not call into question the Director Defendant's *process* of decision-making. Again, the Offer merely quibbles with the level of risk that the Directors chose.[6]

(…continued)
narrowing of corporate bond spreads across virtually all ratings classes and business sectors is a strong vote of confidence in the economic recovery."), *available at* http://www.frbsf.org/publications/economics/letter/2004/el2004-36.pdf (last visited Jan. 23, 2011).

[6] The NCUA alleges that the officers, including Robert Burrell, "exploited" the Directors to get "ever-increasing salaries, bonuses and retirement plans" by receiving compensation tied in part to WesCorp's investment income. Offer at 7:25-8:6. This cheap shot obviously is unrelated to the duty of care claim
(continued…)

2. The allegations about concentration limits and Option ARMs do not establish an exception to the Business Judgment Rule

The NCUA's third set of proposed allegations are about concentration limits and WesCorp's investments in Option ARM MBS. Offer at 8:7-17:8. These allegations either repeat the inadequate content-based allegations of the FAC or underscore the adequacy of the Directors' decision-making processes.

a. Most of the proposed allegations quarrel with content, not process

The Offer alleges that WesCorp did not adopt the concentration limits it would have chosen (with perfect hindsight) for AAA-rated private label MBS, or any concentration limit for Option ARM MBS. Offer at 8:22-27, 9:1-7, 9:22-27, 10:13-22, 11:25-27, 12:11-19. But these allegations simply restate the allegations originally made in the FAC (*see* FAC ¶¶ 30-31, 70-71, 113, 114.d, 114.h) – allegations rejected as inadequate by this Court: "To the extent the FAC takes issue with the failure to adopt any concentration limits for Option ARM mortgage-backed securities . . . these allegations do not satisfy the requirements set forth in *Lee*, 50 Cal. App. 4th 715." Tentative Ruling at 8.

The FAC itself largely concedes that the Directors adopted and followed concentration limits. Thus, the FAC *admits* that:

- Defendants received detailed information about WesCorp's investment

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(…continued)
against the Directors. It also is unrelated to the duty of care claim against Burrell – the only claim against him that NCUA has alleged – and is completely unsupported by the NCUA's factual allegations. Moreover, the allegation is unsupported legally. There is nothing sinister about incentive-based compensation for executives. *Cf. Glazer Capital Management, LP v. Magistri*, 549 F.3d 736, 748 (9th Cir. 2008) (holding that evidence of a personal profit motive on the part of officers contemplating a merger does not raise a strong inference of scienter); *see also* Principles of Corporate Governance § 5.03 (Am. Law Inst. 2005) (executive compensation is a decision subject to all of the protections of the Business Judgment Rule and does not implicate the duty of fair dealing absent improper decision-making process).

portfolio, set, monitored and followed appropriate concentration limits, monitored trends and reacted to trends – lowering their exposure to AA-rated securities after 2005 and ceasing MBS purchases altogether by the summer of 2007. *E.g.*, FAC ¶¶ 62-66, 69-70, 74-77.

- WesCorp classified and tracked MBS investments by rating (AAA and AA) and FICO score (prime, alt-A and subprime), and used the bond rating of investments to track tranche positions. FAC ¶¶ 71-72.
- Defendants regularly attended meetings of WesCorp's Board of Directors and ALCO, and regularly received information about the state of the economy, the investment climate and WesCorp's investment strategy. FAC ¶ 74.
- Defendants received and considered presentations on Option ARM MBS and took affirmative steps to adjust WesCorp's investment strategy based on the information received at ALCO meetings (*e.g.*, starting to get out of AA in 2005). FAC ¶¶ 62-64, 75-77.

The NCUA repeats its contention that concentration limits for private label MBS are particularly important for corporate credit unions, whose fundamental purpose is not to make a profit but to provide services to its members. Offer at 9:8-15. This too is not a new allegation; it was made throughout the FAC and rebutted in the Directors' Reply. FAC ¶¶ 24, 39-40, 43; Doc. 105, at 5:19-6:16. It also was rejected by this Court, which correctly recognized that the Directors were in the business of investing member credit unions' money and thus are entitled to the Business Judgment Rule's protection. Tentative Ruling at 7-8.

b. The process-related allegations do not establish an exception to the Business Judgment Rule

Having made the admissions about process summarized above, the NCUA is left to nibble around the edges of process by alleging that the Directors should have done things slightly differently. These proposed allegations fall into three categories:

First, the Offer alleges that Option ARMs should have raised red flags because they were "liar loans," were "essentially bets" that residential real estate markets would continue to rise, and were new. Offer at 11:1-14.

These pejorative labels may reflect the received wisdom now, but the NCUA does not allege that the Directors knew these alleged facts about Option ARMs *at the time*. Everybody knows – or claims to know – a lot more now than they did during the housing bubble. But the issue is what the Directors knew *then*, not what the NCUA thinks it knows *now* (on the latter subject, see part II.B.2.c below). The Offer alleges no facts suggesting that the Directors knew at the time that Option ARMs were bad news – or why, if they had, they, as unpaid volunteers, would have invested their own credit unions' money with WesCorp.

Option ARMs were not and are not known as "liar loans." That term refers to no-doc/low-doc loans in which originators did not verify borrowers' assets, income, job etc. *See, e.g., N.J. Carpenters Vacation Fund v. Royal Bank of Scotland Group, PLC*, 720 F. Supp. 2d 254, 269 (S.D.N.Y. 2010). Option ARMs are merely ARMs in which the borrower is given the option to vary monthly payments for a time. Were some Option ARMs no-doc/low-doc "liar loans"? No doubt, but so were some fixed-rate 30-year mortgages. The NCUA is confusing the loan type with the originator's care in underwriting the loan.

The Offer alleges that Option ARMs were a "new" type of collateral, but the FAC alleges that WesCorp had been investing in private-label MBS at least since 2002. FAC ¶¶ 50, 55. And the Offer alleges nothing to show that adjustable rate mortgages or, for that matter, Option ARMs really were new. A number of institutions offered Option ARMs successfully for decades before they became so popular in the middle of the last decade. Though their popularity grew markedly in the middle of the last decade, they were not new or novel at that time. Adjustable rate mortgages, and private-label mortgage backed securities containing adjustable rate mortgages, have been around for decades,

received the blessing of Congress and long were viewed as essential to reducing some of the risks facing financial institutions – particularly interest rate risk and liquidity risk. *See Anchor Sav. Bank, FSB v. United States*, 81 Fed. Cl. 1, 11-20 (2008), *aff'd and remanded*, 597 F.3d 1356 (Fed. Cir. 2010) (explaining how and why Congress legalized ARMs early in the 1980's and then encouraged the growth of private-label MBS); *see also* Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (authorizing ARMs).[7]

Second, the Offer alleges that the Directors authorized the purchase of Option ARM MBS without a proper review by WesCorp's employees. Offer at 10:8-12, 10:23-28, 11:15-24, 14:26-15:2. This unsupported allegation is belied by the FAC itself, which admits that WesCorp classified and tracked assets. *See* FAC ¶ 71. The ALCO and the board reviewed WesCorp's investments, including its AAA-rated MBS assets, on a monthly basis and made decisions based upon that review. *See* n.1 above. This process was part of what this Court has already called a reasonable investigation. Tentative Ruling at 6 n.4.

The Offer also suggests that lack of a proper review violated some unnamed WesCorp "policy" for "new" investments. But the Offer identifies no such policy and, as shown above, MBS containing ARMs were far from "new." Besides, the Offer does not say that the Directors knew of this alleged policy, or knew that employees had (allegedly) not complied with it. Even without the Business Judgment Rule, not every unknown failing of employees can be visited

[7] Title VIII of Garn-St. Germain, the "Alternative Mortgage Transaction Parity Act of 1982," authorized ARMs; it is codified at 12 U.S.C. § 3801 *et seq.* Section 3801(a)(2) contains Congress's finding that ARMs "are essential to the provision of an adequate supply of credit secured by residential property necessary to meet the demand expected during the 1980's . . . ." *See also* Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689, which encouraged private-label MBS. Section 105 of the Act amended the Federal Credit Union Act, 12 U.S.C. § 1757, by adding subsection (15), allowing credit unions to invest in MBS.

on Directors. Directors – especially unpaid volunteers like these Directors – set policy and generally oversee the direction of a business; the law does not task them with day-to-day supervision of employees. *See* Cal. Corp. Code § 300(a).

Third, the Offer alleges that the Directors received updates about changing housing market conditions but continued to invest in Option ARM MBS. Offer at 12:26-13:18, 13:25-14:2. It also identifies numerous reports that the Directors received throughout 2006 and 2007. Offer at 12:26-13:24. These allegations demonstrate that the Directors received information about the housing market and its potential effects on WesCorp's investments throughout this period. Far from a failure of oversight, these allegations demonstrate that the Directors continually monitored the economy and WesCorp's investments. As the Tentative Ruling recognized, the FAC's allegations establish that a reasonable investigation into these issues occurred. Tentative Ruling at 6 n.4. The NCUA's new allegations bolster this already reasonable investigation by alleging additional sources of information that the Directors considered.[8]

c. The NCUA's public statements show that its proposed allegations are not plausible

While the Court need not go outside the record before it to affirm its Tentative Ruling, it bears mention that the NCUA's proposed allegations – indeed, the whole thrust of its case – are contradicted by its own public statements made a month or two before it filed the FAC. In a video about corporate credit unions, including WesCorp, publicly distributed to credit unions

[8] To the extent these allegations say that the Directors made the "wrong" decisions based on the information they received (*e.g.*, Offer at 14:3-5), they are allegations about the content of decisions and thus cannot overcome the Business Judgment Rule. Tentative Ruling at 9 (alleging that directors failed to take steps based on information about mortgage-backed securities "takes issue with the decision the defendants ultimately made – a decision the business judgment rule defends . . . .").

last summer and still available in both video and transcribed form from the NCUA, the NCUA made these statements, among many others:

- "Historically mortgage-backed securities experienced no significant losses . . . ."[9]
- "Historically, mortgage-backed securities fit well into the corporate credit unions' business function as a liquidity provider because there was an active market for mortgage-backed securities and they could be used as collateral for borrowing." NCUA Transcript at 7.
- "When corporate credit unions had excess funds on deposit from consumer credit unions who were their members, some purchased private-label mortgage-backed securities with those funds. **The securities offered a better return and were historically just as safe as many other investment products.**" *Id.* at 7 (emphasis added).
- "When the investment requirements for Part 704 [that is, 12 C.F.R. Part 704, the NCUA's regulations for corporate credit unions, none of which WesCorp is alleged to have violated] were implemented, a thorough review was performed on the history of credit ratings and their success in evaluating the financial strength of marketable securities. **The loss history of securities with an initial rating of triple-A or double-A was less than one half of one percent. The loss history of securities issued by government-sponsored entities and the loss history of private label securities was virtually the same.**" *Id.* at 7 (emphasis added).
- "While corporate credit unions were not allowed to rely only on credit ratings,

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[9] NCUA, Transcript of Corporate System Resolution Presentation, Track 2, http://event.on24.com/event/22/07/64/rt/1/documents/player_docanchr_1/transcriptforchapter2.pdf (last visited Jan. 23, 2011) ("NCUA Transcript"), at 6. A video version of the NCUA's presentation may be found on its website at http://www.ncua.gov/Resources/CorporateCU/CSR/Presentations.aspx (last visited Jan. 19, 2011).

the track record of credit ratings in evaluating the future performance of securities was historically strong. Credit ratings have been an investment decision-making tool in financial markets for decades." *Id.*

- "All of the mortgage-backed securities that were purchased by corporate credit unions were permissible at the time they were acquired and accordingly met the rating requirements." *Id.*
- "The securities [private label MBS] offered a better return and were historically just as safe as many other investment products." *Id.*
- "**Based on historic performance, there appeared to be very little risk with the private label mortgage backed securities purchased by the corporates.**" *Id.* at 8 (emphasis added).
- "Finally, many of the securities paid interest based on a floating rate rather than a fixed rate. This helped corporate credit unions in the overall management of their investment and share portfolios, and mitigated the risk of changing interest rates." *Id.*

3. The allegations about damages have no relevance to the Business Judgment Rule

The NCUA's fourth and final set of allegations deals with the losses suffered by WesCorp. Offer at 16:26-17:8. The NCUA alleges that WesCorp lost $2.5 billion on its Option ARM investments. *Id.* at 16:26-28. The NCUA also alleges that WesCorp's failure jeopardized the entire credit union system. *Id.* at 17:1-8. These allegations have nothing to do with overcoming the Business Judgment Rule. They are emblematic of the weakness of the NCUA's Offer: having nothing to say about the Business Judgment Rule, the NCUA once again trots out the specter of big damages. *See* Reply in Support of Directors' Motion to Dismiss, Doc. 105, at 18:11-16.[10]

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[10] While the Directors recognize that the Tentative Ruling rejects their statute of
(continued…)

C. The NCUA's legal arguments are procedurally improper and wrong

1. The NCUA's legal arguments amount to an unauthorized motion for reconsideration

In the second part of its Offer (17:9-19:8), the NCUA inappropriately tries to reargue points of law that it lost at the last hearing. This Court granted the NCUA the opportunity to present, in writing, additional factual allegations that would establish an exception to the Business Judgment Rule. It did not grant the NCUA leave to reargue the motions to dismiss or repeat its flawed understanding of the law. This part of the Offer amounts to an inappropriate motion for reconsideration.

The Local Rules place strict limitations on motions for reconsideration. Local Rule 7-18 allows motions for reconsideration in very limited circumstances, none of which apply here. The first situation is where there is a "material difference in fact or law" which could not have been reasonably known to the party seeking reconsideration. The second situation is where new material facts emerge or the law changes after the hearing. The NCUA's legal arguments merely restate the points it made before, and re-cite the cases it cited before; thus, neither the first or second situation applies. The third and final situation is where there is a manifest showing of a failure to consider material facts presented to the court at the hearing. This ground is irrelevant to the purely legal arguments presented by the NCUA – which in any event merely reargue points considered and rejected (not ignored) by the Court.

(…continued)
limitations argument on Claim One (Tentative Ruling at 15-16), they respectfully note that the NCUA's proposed allegations focus almost entirely on events after Cheney, Rhamy and Updike allegedly left the Board early in 2006. The few allegations reaching back before 2006 do not raise any red flags or charge the Directors with any wrongdoing; they merely note committee memberships or make allegations about officers and staff, not Directors. *See* Offer at 2:20-26, 10:1-7, 11:15-18.

2. The NCUA's legal arguments are wrong

Contrary to the NCUA's argument, which it made and lost before (*see* Doc. 102, at 12 n.7; Doc. 105, at 11:20-12:7 & 12 n.5), California cases interpreting the Business Judgment Rule do not distinguish between cases in which plaintiffs seek to force corporate acts through injunctive relief and cases in which plaintiffs seek to recover money damages from directors. In both, the court must limit itself to evaluating the process of decision-making because of the danger of hindsight bias. Indeed, *Berg & Berg Enterprises v. Boyle LLC,* 178 Cal. App. 4th 1020, 1045, 100 Cal. Rptr. 3d 875, 897-98 (2009), discusses the common law component of the rule in the context of an action for damages against directors. The broader common law component is simply a policy of judicial deference to director decision-making, regardless of the relief sought. Business decisions are business decisions, and courts are equally poor at avoiding hindsight bias whether a plaintiff seeks injunctive relief or damages.

The NCUA argues that only Corporations Code section 309 or 7231 applies when a complaint seeks money damages from directors, and that cases interpreting the common law component of California's Business Judgment Rule are irrelevant. Offer at 17:10-18:5. The NCUA does not cite any case, treatise or law review article that supports its position. Instead, it relies on a single sentence of dictum from *Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n,* 21 Cal. 4th 249, 980 P.2d 940 (1999). Offer at 17:21-25. Yet *Lamden* itself calls this conclusion into question: it defines the common law component of the Business Judgment Rule as a judicial policy of deference to corporate business decisions. *Lamden*, 21 Cal. 4th at 258. Directors' business decisions are equally challenged whether a plaintiff seeks money damages or injunctive relief. At a policy level, there is no difference between the two: courts could distort corporate action by improperly intervening at the time of the decision-making with injunctive relief or after the fact of decision-making with ruinous money

damages, such as the $6.8 billion the NCUA seeks here.

Indeed, none of the cases that discuss California's statutory and common law Business Judgment Rule draws the distinction that the NCUA proposes. *Castetter*, while relying on section 309, nevertheless refers to the quintessential common law justification for protection of directors' business judgment: "afford[ing] directors broad discretion in making corporate decisions and to allow these decisions to be made without judicial second-guessing in hindsight." *Castetter*, 184 F.3d at 1044 (citing *Barnes v. State Farm Mut. Auto Ins. Co.*, 16 Cal. App. 4th 365, 378, 20 Cal Rptr. 2d 87, 95 (1993)). The NCUA cites *Barnes* as showing that the Rule is somehow different outside of the section 309 context (Offer at 18:6-11), yet the *Castetter* court relied on *Barnes* in applying section 309. In other words, the *Castetter* court – like every other court that has applied California's Business Judgment Rule – did not draw the distinction the NCUA proposes, even when confronted with exactly the situation to which it would theoretically apply. *See also Berg & Berg*, 178 Cal. App. 4th at 1045 (discussing the common law component of the Business Judgment Rule although plaintiff sought money damages).

Section 309 is an attempt to clarify – not to supplant – California's common law Business Judgment Rule. The NCUA's attempt to limit the protection of California's Business Judgment Rule is unsupported by both the common law and the Corporations Code. But even if Corporations Code section 309 or 7231 were the final word on director liability for damages, the NCUA would still need to plead an exception to the Business Judgment Rule. The *Castetter* court, for example, looked to section 309 and did not discuss the common law, yet held that the same exceptions to the Business Judgment Rule apply. *See Castetter*, 184 F.3d at 1046. The lesson of *Castetter* is not that directors without a background in banking are the only ones that can get away with business mistakes. Offer at 18:1-2. The lesson of *Castetter* is that courts

should limit themselves to a review of the process of decision-making in order to avoid hindsight bias. *Castetter*, 184 F.3d at 1044. The process that the Directors used to make investment decisions as alleged in the FAC and in the Offer is analogous to the process used to make decisions in *Castetter*, and the Directors should be protected from personal liability, as were the defendants in *Castetter*. *See* Tentative Ruling at 9.

The NCUA's interpretation of California Business Judgment Rule is mistaken, and does not free it from the requirement of adequately pleading an exception to the Business Judgment Rule.

3. The NCUA's district court opinion from Connecticut has nothing to say about the application of California's Business Judgment Rule

In the final section of its Offer (19:9-13), the NCUA points to *FDIC v. Healey*, 991 F. Supp. 53 (D. Conn. 1998), as an example of a case that post-dates *Atherton v. FDIC*, 519 U.S. 213, 117 S. Ct. 666 (1997), and includes both a claim for breach of fiduciary duty under state law and claim for gross negligence under 12 U.S.C. § 1821(k). While the complaint in *Healy* included both claims (*see* 991 F. Supp. at 55), that was not an issue in the case, and the court gave the point no consideration. Instead, *Healy* is about whether a common-law "no duty" rule applies to FDIC's *post*-receivership acts and accordingly whether affirmative defenses of a failure to mitigate and contributory negligence can apply. *Id.* at 55-56. Thus, while the court mentioned *Atherton*, it appropriately found it irrelevant to the issue at hand, stating that "*Atherton* did not resolve the issue presented in the instant case, because *Atherton* concerned the proper standard of care applicable to pre-receivership conduct of former officers and directors of a failed institution." *Id.* at 60. (In dicta, the court did discuss the holding in *Atherton*, construing it exactly as this Court does. *Compare id.* at 57 *with* Tentative Ruling at 14-15.)

Even if *Healy* had considered the question raised here by the NCUA, the

proper application of the statute is uniquely a question of state law. *Healy* does not involve California law; *Healy* arose in Connecticut. In contrast, *Castetter*, 184 F.3d at 1043-44 – which has the virtue of being binding Ninth Circuit precedent – explicitly resolves the question under California law. This Court thus properly followed *Castetter* (Tentative Ruling at 14-15) and should ignore *Healey*.

III. CONCLUSION

The Court has been liberal with the NCUA by giving it this opportunity to make a written offer of proposed allegations. But that policy has its limits. It is one thing to treat liberally a private plaintiff who has been forced to plead a claim against corporations or their directors without any access to the corporation's records. *Cf. Eminence Capital, LLC v. Aspeon Inc.*, 316 F.3d 1048 (9th Cir. 2003). But it is another thing to extend the same liberality to a government agency that has controlled WesCorp for the last year and a half, with complete access to all its books and records, and the untrammeled ability to interrogate its employees without anyone representing the Directors in the room. Where there is no reason to think amendment would cure the defects in the FAC, there is no reason to grant leave to amend, even the first time around. *Cf. In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1163 (C.D. Cal. 2007). This is such a case. We said that before (Doc. 96-1, at 24:13-24); the manifest deficiencies in the NCUA's Offer merely proves the point. For all these reasons, the FAC should be dismissed as to the Directors without leave to amend.

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Dated: January 24, 2011.

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